Accounting for leasing - exercise

Task: A company XYZ agrees to lease a fixed asset:

- **Estimated useful life - 5 years**
- **Lease period - 5 years**
- **Once the lease period ends the asset will be returned back to the lessor**
- **Annual rental for the fixed asset - $14,000**
- **Residual value at the end of the leasing term - $0**
- **Fair value of the fixed asset - $50,000**
- **Interest payment per year – 8%**

What is the right way to account for this lease? How is accounting going to look like at the end of year 1?

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Accounting for leasing - solution

Solution:

(1) This is a finance lease – the fixed asset's estimated useful life is 5 years and the company leases the asset for 5 years

(2) We have to recognize the asset we are leasing and the liability we have:

Debit Fixed Assets $50,000
Credit Leasing Liabilities $50,000

(3) Calculate depreciation:

$50,000 / 5 years = $10,000 per year

(4) Account for depreciation:

Debit D&A $10,000
Credit Accumulated Depreciation $10,000

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Solution:

(5) Calculate leasing scheme

Year	Starting	Interest (8%)	Rental	Ending
1	$50,000	$4,000	($14,000)	$40,000
2	$40,000	$3,200	($14,000)	$29,200

(6) Account for interest expenses:
Debit Interest expenses $4,000
Credit Liabilities against lessor $4,000

(7) Balance Sheet entries
Carrying value of the asset at the end of year 1 - $40,000 ($50,000 – 10,000)
Lease liability at the end of year 1 - $40,000

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